TRENDS

PRINCIPLES VERSUS RULES IN BEGINNING ACCOUNTING: UNDERSTANDING THE LEHMAN CASE[1]

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Monday, September 15, 2008 followed, "One of the most tumultuous weekends in Wall Street's history. . . There would be no bailout of Lehman Brothers Holdings Inc."[2] Lehman's bankruptcy led to one of the largest runs of the Federal Reserve and U.S. banking system in history as it was followed almost immediately by federal bailouts of Goldman Sachs, Bank of America, Bear Sterns, Morgan Stanley, Citigroup, and Merrill Lynch. Lehman agreed to pay three of its departed executives more than $23 million. Chief Executive Richard Fuld was called before a congressional committee under accusations of deceiving investors about the financial health of Lehman. He was asked "about the juxtaposition of upbeat public comments he and other Lehman executives made about the firm and the dire internal review of Lehman's growing problems."[3] Mr. Fuld denied misleading investors said that Lehman was brought down by outside forces including short sellers.[4] By December 2010, with more $1.2 billion in fees already paid out to more than 40 firms of consultants, attorneys, accountants, restructuring firms and others to unwind the securities firm's operations and derivatives contracts, there were more then $39 trillion in derivatives from 891,752 trades still needing to be unwound.[5]

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[1] This *Trends* is based on a longer study made by the author during his year (2010-2011) as the Wicklander Fellow in Business Ethics at DePaul University.

[2] Solomon, D., Berman, D. K., Craig, S., & Mollenkamp, C. (2008, September 15). "Ultimatum By Paulson Sparked Frantic End." *The Wall Street Journal*, A1.

[3] Craig, S. (2008, October 7). "Lawmakers Lay Into Lehman CEO," *The Wall Street Journal*, A3.

[4] Ibid.

[5] Moyer, L. (2010, November 23). "Lehman Fees Hit $1 Billion and Counting." *The Wall Street Journal,* C1; Michael Corkerty and Katy Burne (2011, June 13, 2011), "Rattled by Lehman—Again," *The Wall Street Journal,* C1

Lehman is only one of a number of high-profile cases that have highlighted the role of financial reporting and the issues surrounding earnings management in recent years. The flood of these so-called 'accounting scandals' and the alarming increase in accounting revisions and restatements has drawn the attention around the globe by accounting researchers and the popular press alike. The principles-based versus rules-based standards debate is discussed and illustrated with the case of Lehman's accounting for Repo 105 transactions, which clearly highlights the issues that this debate raises.

The Principles versus Rules debate. It is often asserted that U.S. GAAP is more rules-based than principles-based.[6] A precise definition of this distinction is elusive, but it generally means that U.S. GAAP relies more on "bright-line" demarcations of alternative accounting treatments than on judgment in the application of the conceptual framework.[7] For instance, equity accounting is used for long-term investments less than 50 percent ownership and consolidation accounting is used for those with over 50 percent ownership. Under principles-based standards, it is asserted that substance should rule over form and that judgment should be used to determine whether, for instance equity or consolidation accounting, should be used when the investment hovers around 50 percent. The movement to principles-based standards was given a lift by the Securities and Exchange Commission (SEC) when after Sarbanes-Oxley it endorsed principles-based standards in 2003 as providing "more transparent information about a company's financial results and position. . . "and recommending that new standards "avoid use of

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[6] Excellent discussion of the merits of principles-based and rules-based standards may be found in Nelson, Mark W. (2003, March). "Behavioral Evidence on the Effects of Principles- and Rules-Based Standards," *Accounting Horizons* 17 (1): 91-104; Maines, L., Bartov, E., Fairfield, P., Hirst, E., Iannaconi, T., Mallett, R., Schrand, C., Skinner, D., & Vincent, L. (2003). "Evaluating Concepts-Based vs. Rules-Based Approaches to Standard Setting," *Accounting Horizons* 17 (1): 73-89.; and Schipper, Katherine. (2003, March). "Principles-Based Accounting Standards," *Accounting Horizons* 17 (1): 61-72.
[7] Rebecca Toppe Shortridge and Mark Myring. (2004, August). "Defining Principle-Bases Accounting Standards," *The CPA Journal*, p. 34.

percentage tests--so-called bright lines—that allow financial engineers to achieve technical compliance with the standard while evading its intent."[8]

It is thought that rules-based standards are more easily defended in the litigious U.S. economy. Donelson, McInnis, and Mergenthaler studied firms that restated their financial statements. Some of these firms were sued, and some could have been credibly sued, but were not. They found that "firms are less likely to be sued when they violate standards that are more rules-based, consistent with the view that the complexity of rules-based standards provides a credible—innocent misstatement—presumption. This result is not only statistically significant, but is also economically meaningful."[9] The authors showed that a one-unit increase in the RBC measure (i.e., the incremental presence of one of the four characteristics of rules-based standards) is associated with an 11-percentage point decrease in the likelihood of being sued.

On the other hand, they provide evidence of filed lawsuits that potential plaintiffs take into account the rules-based nature of standards violated when deciding whether to file a lawsuit. Given the--innocent misstatement--defense, many rules-based cases likely get screened out at the filing stage, leaving only relatively strong rules-based violation cases being filed. Thus, plaintiffs work to ensure that there is no relation between violations of rules-based standards and lawsuit outcomes once the filing decision is made. These findings suggest violations of rules-based standards are associated with a lower threat of litigation.[10]

Supporters of a more principles-based approach including SEC Chairman (at the time) William Donaldson argue that this is "an approach to setting accounting standards that should result in investors receiving more transparent information about a company's

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[8] S. Taub. (2003, July 29). "SEC Study Endorses Principle-Based Accounting," *CFO.com.* <http://www.cfo.com/article.cfm/3010031/1/c_3043317?f=related&origin=arch...>

[9] Donelson, Dain C., McInnis, John M. and Mergenthaler, Richard Dean. (2010, December 1). "Rules-Based Accounting Standards and Litigation." McCombs Research Paper Series No. ACC-06-10. Available at SSRN: http://ssrn.com/abstract=1531782

[10] Ibid.

financial results and position." The SEC adds that a principles-based approach "should ultimately result in more meaningful and informative financial reporting to investors and hold management and auditors responsible for ensuring that financial reporting complies with the objectives of the standards."[11] Two recent studies have provided empirical evidence supporting a principles-based approach. Mergenthaler (2009) finds that rules-based situations are associated with larger magnitude of earnings management and that there is a "negative correlation between rules-based characteristics and the probability of being penalized by the SEC."[12] Folsom et. al. (2011) find that "earnings are more informative, are more persistent, and better predict future cash flows when the firm relies on principles-based standards."[13]

The International Accounting Standards Board (IASB) has embraced the principles-based approach by basing its standards on the conceptual framework and by not proving detailed guidance or industry guidance in most cases. Sir David Tweedie, Chair of the IASB, is quoted as responding to a question about Repo 105: "We don't allow it. That's why we have principles, not rules, so you can't do it."[14] The contrast between the FAS standard setting process and that of the IASB can be shown by the fact that there are approximate twenty-five FASB standards with much industry guidance for revenue recognition and only two IFRS with limited guidance for revenue recognition. The convergence project of the FASB and IASB is giving attention to the principle-based approach by focusing first on agreement as to the underlying conceptual framework of the standards.[15]

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[11] Taub S. (2003, July 29). "SEC Study Endorses Principle-Based Accounting," *CFO.com*.
<http://www.cfo.com/article.cfm/3010031/1/c_3043317?f=related&origin=arch...>

[12] Richard Mergenthaler, Jr., "Principles-Based Versus Rules-Based Standards and Earnings Management," *Social Science Research Network,* December 26, 2009, 1.

[13] David Folsom, Paul Hribar, Rick Mergenthaler, and Kyle Peterson, "Principles-Based Standards and The Informativeness of Earnings, *Working Paper, (April, 2011), 2.*

[14] "Accounting Boards to Work on Repo Transactions," (2010, April 17). *AccountingToday.com.*

[15] FASB, IASB. (2010, December 1). "Convergence Priorities on Target for 2011," *Journal of Accountancy*. <http://www.journalofaccountancy.com/Web/20103607.htm>

<u>Case study:</u> Here, we will examine the case cited at the beginning of this paper as the key inflection point during the most critical phase of the recent financial crisis: the failure of **Lehman Brothers** in September 2008. Lehman provides a stark example of how rules-based standards allow financial firms to maneuver their operations to "optimize" regulatory and accounting treatment. For internationally active firms, differences between U.S. and foreign tax, accounting, and capital regimes have prompted firms to structure their activities to minimize these constraints. As the SEC has acknowledged by attempting to regulate so-called "window-dressing" by proposing rules that helped investors identify firms that reduce debt before quarterly reports,[16] its voluntary oversight regime allowed Lehman and other investment banks to operate with too much leverage and risk. Accounting arbitrage has also been widespread. Lehman moved certain assets off-balance sheet through repo transactions executed in its London broker-dealer subsidiary. These transactions were designed to reduce the firm's reported leverage ratio (debt to equity) at quarter-end.

Standard setters are attempting in different ways to address the issue of Repo-type transactions. The SEC has proposed rules that would require public companies to disclose additional information about their short-term borrowing, regardless of how such arrangements are accounted for.[17] Similarly, the IASB amended IFRS 7 by proposing additional discloses if a disproportionate amount of financial-asset transfer transactions are undertaken around the end of the reporting period.[18] The FASB, on the other hand, is considering dropping its "bright-line" criterion (the 102 Rule) that enabled Lehman to avoid by using Repo 105 transaction.[19] It has also improved the criteria for effective control by eliminating consideration of the transferor's ability to fulfill its contractual rights and obligations.[20]

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[16] Kara Scannell and Michael Rapoport. (2010, September 18-19). "United SEC Votes to Propose Pulling Back Drapes on Debt," *The Wall Street Journal.*
[17] Securities and Exchange Commission. (2010, September 17). *Release No 33-943*.
[18] International Accounting Standards Board. (2010, October 7). *Amendment to IFRS No. 7: "Financial Instruments Disclosures.*"
[19] Bruce Pounder. (2011, January). "One Problem, Three Fixes," *Strategic Finance*, 20.
[20] Financial Accounting Standards Board, "Transfers and Serving (Topic 860) Reconsideration of Effective Control for Repurchase Agreements," *ASU No 2011-03*.

In spite of the above, the Lehman case to not as black and white as it might seem on the surface. Lehman did use Repo 105 to improve its leverage ratio (debt to equity) quarter after quarter until it imploded in the second quarter of 2008.[21] Also, interestingly it is not strictly "earnings" management but is better called "debt or balance sheet" management. Also, Lehman followed US GAAP under SFAS 140. So, it raises the question of rules versus principles. Under this rule, to qualify for sales treatment, a firm has to show that it no longer controls securities being exchanged in repo transaction. A possible proof of transfer of control is that the securities exchanged are worth more than the cash received. Guidance in accounting standards (rules) suggest that transfers in excess of 102 percent would qualify as transfer of control. Thus, Lehman exchanged securities worth 105 percent of the cash received, which is why they are called Repo 105 transactions.[22] Is it enough to follow the rule? Let us examine the difference between the accounting for a typical repo transaction and the Repo 105 transaction.[23]

Under a typical Repo, cash is borrowed under a short-term payable as follows:

Cash	100M	
Short-term payable		100M

As a consequence, the collateral assets behind the loan stay on Balance sheet with footnote disclosure. Thus, there is no effect on leverage ratio. When the loan is repaid within 30 days with interest, the repayment is recorded thusly:

Short Term Payable	100.0M	
Interest Expense	.2M	
Cash		100.2M

[21] Lehman also engaged in Repo 108 transactions involving equity securities, which are accounted for similarly.

[22] David Reilly. (2010, March 15). "Questions on Ernst Auditing," *The Wall Street Journal*.

[23] These examples are based on Dutta, S. K., Caplan, D., & Lawson R. (2010, August). "Lehman's Shell Game," *Strategic Finance,* 23-29.

Lehman, however, reconfigured the typical repo transaction into the repo 105 in which the collateral assets (in this case, investment securities) are actually transferred to the creditor with a future option to repurchase, as follows:

Cash	100M	
Future Option to repurchase	5M	
Investment Securities		105M

In this transaction, no liability is recorded and no gain or loss is recognized. Total assets and liabilities remain unchanged. Thus, Lehman meets the requirements of Para 218 of SFAS 140: A transfer of financial assets in which the transferor surrenders control over those assets is accounted for as a sale--not a loan. Lehman then uses the cash to pay liabilities, as follows:

Short-term Payable	100M	
Cash	100M	

Thus, Lehman's leverage ratio is improved through a reduction in debt and the company meets regulatory leverage requirements. Within thirty days after the end of the period, Lehman re-borrows the funds and repurchases the collateral assets, as follows:

Cash	100.0M	
Short-term Payable		100.0M

Investment Securities	105.0M	
Interest Expense	.2M	
Cash		100.2M
Future Option to Repurchase		5.0M

Note that Lehman's income does not differ materially in this transaction from those in an ordinary repo. However, if Lehman were not to exercise their option to "buy" the investment securities, they would lose the 5 percent of the excess of the securities transferred over the amount of cash received. This heavy penalty ensures that the repurchase with interest will be made.

Over the past three years, Lehman was able to improve its leverage ratio and net leverage ratio is each year:

	2008	2007	2006
Leverage ratio	21.1x	24.3x	31.7x
Net leverage ratio	10.6x	12.1x	15.4[24]

And in the last three quarters before bankruptcy, Lehman continued to use Repo 105 to improve its leverage, as follows:

- Nov. 07: 38.6M (10.6% improvement in leverage)
- Feb. 08: 49.1M (13.3% improvement in leverage)
- May 08: 50.4M (14.9% improvement in leverage)[25]

This treatment under SFAS No. 140 raises a number of questions:

- Even if Lehman's use of Repo 105 meets the requirements of SFAS 140, does it represent the substance of situation?
- Does it meet the risks and rewards of a sale?
- Would a statement user be affected by knowledge of the repurchase agreement?
- Should the auditor's decision be different under IFRS where judgment plays more of a role than rules under U.S. GAAP?

Repo 105 transactions were similar to repurchase agreements in the following ways:

- Lehman continued to receive the stream of income from the securities it transferred.
- As in an ordinary repos, Lehman was obligated to "repurchase" the transferred securities at a specified date.
- Lehman used the same documents as in an ordinary repo.

Thus, Repo 105 transactions were similar in substance to ordinary repo transactions.

It is clear that Lehman's balance sheet is shored up at the end of each period, but if we examine the quality of earnings as represented by the cash flow yield an entirely different story unfolds:

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[24] Lehman, Inc. (2009). *2008 Annual Report.*

[25] Dutta, Caplan, & Lawson, op.cit., 26.

	2008	2007	2006
Net cash flows from operating activities	($43,595)	($36,376)	($12,205)
Net income	$4,192	$4,007	$3,260
Cash flow yield	(10.39x)	(9.08x)	(3.74x)

Clearly, Lehman's quality of earnings have been negative and become more negative in every year. Lehman has long been a train headed for a wreck. What is the auditor's response to the repo 105 transactions? The following are key paragraphs from the auditor's managing partner with regard to the Lehman accounting:

> While no specific disclosures around Repo 105 transactions were reflected in Lehman's financial statement footnotes, the 2007 audited financial statements were presented in accordance with U.S. GAAP, and clearly portrayed Lehman as a leveraged entity operating in a risky and volatile industry. Lehman's 2007 audited financial statements included footnote disclosure of off balance sheet commitments of almost $1 trillion.
>
> EY's last audit was for the year ended November 30, 2007. Our opinion stated that Lehman's financial statements were presented fairly in accordance with US GAAP, and we remain of that view. We reviewed but did not audit the interim periods for Lehman's first and second quarters of fiscal 2008.[26]

This excerpt clearly states the rules-based defense of the accounting treatment whereas plaintiffs will likely emphasize the misjudgments made from principles-based substance-versus-form standpoint. Although it is clear that the interim statements were not audited, it is important to note that reviews, although involving less verification than an audit does, do, however, require the financial statements to be presented in conformity with US GAAP.

Nevertheless, in hindsight, there were warnings and missteps. In a May 2008 letter to chief financial officer and chief risk officer and only days before he was ousted, Matthew Lee, a Lehman Senior Vice-President, warned that he believed senior management may have violated Lehman's internal code of ethics by misleading investors about the true

[26] Ernst & Young. (2010, April). *Letter for Clients*.

value of the firms assets.[27] Amazingly, the chief executive officer and the chief financial officer have stated that they either did not know of the Repo 105 transactions or could not recall them.[28] SEC Chair, Mary Shapiro, has acknowledged the SEC's oversight of Lehman was inadequate during a critical time.[29] Further the bankruptcy examiner in the Lehman case has raised questions about the auditor's role in the conduct of the audit of Repo 105 transactions.[30]

It is reported that "SEC officials have grown increasingly doubtful they can prove that Lehman violated U.S. laws" by engaging in repo transactions.[31] Since it is unlikely now that Lehman executives will face charges, attention is focused on the auditor including on a charge that the auditor allegedly failed to follow up on a whistleblower's claim that Lehman was misstating the value and size of its assets.[32] New York Attorney General Andrew Cuomo has sued Ernst & Young for allegedly helping Lehman mislead investors by helping to downplay Lehman's liabilities.[33] The Public Company Accounting Oversight Board (PCAOB) has had little choice but to open an investigation of Ernst & Young and its role in the failure of Lehman Brothers. It joins the Securities and Exchange Commission in looking at how the firm handled the Repo 105 highest-profile enforcement action since it began bringing cases in 2005. On December 21, 2010, the New York Attorney General sued Ernst & Young accusing the firm of facilitating a "major accounting fraud" by helping Lehman deceive the public about its financial

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[27] Michael Corkery. (2010, March 20-21). "Lehman Insider's Letter Warned About Violating Code of Ethics," *The Wall Street Journal,* B1, B3.
[28] Mike Spector and Michael Corery. (2010, March 20-21). "What Lehman's Central Players Knew," *The Wall Street Journal*, B3.
[29] Fawn Johnson. (2010, March 18). "SEC on Lehman: Not Good Enough," *The Wall Street Journal*.
[30] David Reilly, *op.cit.*
[31] Jean Eaglesham and Liz Rappaport. (2011, March 12). "Lehman Probe Stalls; Change of No Changes," *The Wall Street Journal.*
[32] Steve Eder. (2011, March 14). "Lehman Auditor May Bear The Brunt," *The Wall Street Journal*.
[33] "Cuomo Sues Ernst & Young in Lehman Case." (2010, December 21). *Bloomberg News*, 3B.

condition for seven years.[34] Ernst & Young replied that there was no legal or factual basis for the legal claim against it.[35]

There are arguments in Ernst & Young's favor in additional to the fact that Lehman did not violate the FASB "rule":

- The securities in the Repo 105 transaction were not "Toxic or "junk," but were the highest quality Lehman owned.
- Repo 105 transactions did not cause or contribute to Lehman's bankruptcy.
- Lehman did not attempt to hide its Repo 105 transactions from auditors or regulators.[36]

Nevertheless, the PCAOB also issued a warning to auditors to be alert for unusual deals. "Significant unusual transactions, especially those close to period end that pose difficult 'substance over form' questions can provide opportunities for companies to engage in fraudulent financial reporting," the PCAOB said in the alert.[37] That follows an alert about improving communications between the board and the audit committee. Both seemed to flow from the Ernst & Young-Lehman Brothers situation. Further, the FASB has recently proposed changes in rules for repro-type transaction. In a statement, FASB Chair Leslie F. Seidman states, "The new guidance [in ASU No. 2011-03] improves transparency by eliminating consideration of the transferor's ability to fulfill its contractual rights and obligations from the criteria in determining effective control."[38]

Some people are mentioning Ernst & Young in the same breath as Arthur Andersen, which was given the death penalty after the Enron crisis. It is doubtful, however, that regulators will impose such a penalty, but the real harm may come from civil litigation.[39]

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[34] *Ibid*.
[35] Liz Rapoport and Michael Rapoport. (2010, December 21). "Ernst Accused of Whitewash," *The Wall Street Journal*.
[36] Bruce Pounder. (2011, January). "One Problem, Three Fixes," *Strategic Finance*, 21.
[37] Public Company Accounting Oversight Board. (2010, April 7). "Staff Audit Practice Alert No. 5: Auditor Considerations Regarding Significant Unusual Transactions."
[38] Michael Cohn. (2011, April 29). "FASB Changes Rules for Lehman-Like Repo Agreements, *Accounting Today*.
[39] Kim, Jim. (2010, April). For Ernst & Young, fallout continues over Lehman Brothers issues.

However, the judge in the Lehman case has ruled that Lehman did not violate accounting standards at the time (2008) and that there must be evidence that "the auditor did not actually hold the opinion it expressed or that it knew it had no reasonable basis for believing that those balance sheets fairly presented" the company's financial position. The judge rule in other words, held that since Lehman followed the accounting *rules* at the time, there was no reasonable basis for Ernst & Young to know that the statements were misstated.[40] Clearly, a rules-based approach, as opposed to a principles-based based approach, on the part of the judge.

< http://www.fiercecomplianceit.com/story/fallout-ernst-young-over-lehman-brothers-issues-continues/2010-04-13>

[40] Floyd Norris. (2011, July 28, 2011) "Lehman Case Hints at Need to Stiffen Audit Rules," *NY Times.com.*